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Reconciling the Chinese Financial Development with its Economic Growth: A Discursive Essay

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Abstract

Focused on the case of China's financial development, the present discursive essay sets out to argue that if the Chinese financial system distorted the allocation of funds then economic growth could not be sustained and financial depth would remain deficient. The essay puts forward selected financial facts and policies, discusses their relevance in the particular context of China's economic development goals and concludes that although the Chinese financial system is not developed according to the standards of industrialized countries, financial intermediation has nevertheless been efficient in terms of promoting savings and credit to the extent that might have been good enough to facilitate economic growth. Furthermore, in order to reconcile China's financial efficiency-growth apparent paradox, the essay supports the view that analyzing China's financial system using market-based standards may not be valid.

Keywords: Financial Development, China, Financial Policy, Monetary Policy

1. Introduction

The theoretical argument for linking financial development to economic growth is that a well-developed financial system performs several critical functions to enhance the efficiency of intermediation by reducing information, transaction, and monitoring costs. The above link suggests that economic growth rarely (if ever) occurs without a well-functioning financial system (see McKinnon, 1973; Shaw, 1973; King & Levine, 1993; Levine et al. 2000; Beck et al. 2000). Put in different terms, if the financial system distorts the allocation of funds and financial repression is in place then economic growth could not be sustained and financial depth (as defined by Shaw, 1973) would remain deficient.

The strong economic performance occurring in China over the last two decades (China's real GDP growth averaged at 9.4 %) is extremely difficult to reconcile with the standard view that China's financial system grossly distorts the optimal allocation of loanable funds and that its financial sector has been seriously inefficient. The essay attempts to address the following set of questions.

- How to better understand the Chinese financial system?
- To what extent did financial policies implemented in China contribute to the achievement of the country's development goals?
- Does the strong economic growth in China reflect the effectiveness of its financial system?

The present essay argues that analyzing the Chinese financial system using market-based standards may not be valid and that the present Chinese financial system has never the less been effective in serving the development needs of China. Furthermore, although the Chinese financial system is not developed according to the standards of industrialized countries, financial intermediation has never the less been efficient in terms of promoting savings and credit to the extent that might have been good enough to facilitate economic growth.

The essay is structured as follows.

- Section 2 reviews selected institutional facts on the Chinese financial development and the progress accomplished after 1978.
- Section 3 discusses different angles from which the performance of the Chinese financial system can be correctly assessed and it also focuses on financial policies.
- Section 4 concludes the essay.

2. Overview of the Chinese financial development

To understand the Chinese financial system, it is important first to review the Chinese financial development in terms of institutions and development performance. The focus is on the banking sector since it accounts for most, if not all, of the financial activities in China.

2.1. Institutional Setting

Since China adopted the reform and opening-up policy, its financial market has not only accommodated commercial banks, social security funds, trust companies, insurance companies and securities companies but it also has introduced, since 2003, qualified foreign institutional investors (QFII), which have played an important role in the development of the Chinese financial market. Furthermore, products in the financial market have gradually been diversified. While there are financial debts, treasury bonds, central bank bills, corporate equity and other products with features of debt, innovative securities and banking products have been continuously introduced (Zhou Xiaochuan, 2004)

The financial assets of China are concentrated in the banking system; the capital markets are relatively small and bank loans remain the dominant source (above 80 percent) of funding for Chinese companies. No real corporate debt market exists. According to Ligang (2001), bank loans are the main source of finance in China. In 1998 bank loans represented 70 per cent of total financing, while equity financing accounted for only 6 per cent. Private commercial banks are a very small part of the market. Under the government's guidance, the state banks have directed most of their funds to the State Owned Enterprises (hereafter SOEs) through 'policy loans' and direct credits at interest rates far below the market value. Loans are mainly short term, although there has been a recent trend toward medium- and long-term lending.

Over 80 city commercial banks have approximately 4 percent of the domestic banking business. Urban credit cooperatives (about 3,200) have approximately 5 percent of the domestic banking business. Numerous (about 41,500) rural credit cooperatives and other small institutions have approximately 9 percent of the domestic banking business (Ligang, 2001).

The banking sector is heavily concentrated around the big 4 state-owned banks (hereafter SOBs) that represent 60-70 percent of the domestic banking business, measured in terms of total assets. These big 4 banks are:

- the Bank of China (traditionally responsible for foreign exchange activity and the financing of imports and exports),
- the Industrial and Commercial Bank of China (originally specialized in lending to the industrial sector),
- the China Construction Bank (traditionally focused on financing infrastructure development) and
- the Agricultural Bank of China (traditionally focused on agricultural lending and rural development).

At the end of 2001, they had a 62 % share of the savings and lending business and an 80 % share of the payments business.

According to Xinghai (2001), the Chinese government carried out many reforms in the financial sector since 1995 notably Centralizing government control of large banks, insurance companies and stock exchanges; forcing the collectivization of urban credit unions; abolishing

loan quota and establishing asset management companies to deal with non-performing loans (hereafter NPL).

To allow the rest of the SOBs to concentrate on more commercially-oriented lending, a new Commercial Banking Law (CBL) promulgated in 1995 emphasized the need for financial institutions to incorporate commercial criteria into their lending practices. The Chinese government set up three state banks with special functions: the State Development Bank, the Agricultural Development Bank of China and the Export and Import Bank of China, with the mission for implementing government steering policy and providing funds for reconstruction projects.

Despite the introduction of the Central Bank Law, which gave sweeping powers to the People's Bank of China (PBOC) to implement monetary policy and to exercise financial supervision over the other financial institutions, the PBOC, hardly constituted an independent entity. The development of new financial products, and determination of interest rates on loans remain subject to government control. In his exhaustive study, Lardy (1998) points out the fact that — reminiscent of the central-planning era—almost all banks in China are state-owned.

The high concentration of the banking sector is illustrated by the excessively high ratio of broad money (M2) to GDP, which indicates that financing relies too heavily on the banking system in the course of the economic development. Notwithstanding the trend of the high M2 ratio over time, a pattern of strong and successful financial development in China has been confirmed.

2.2. Financial Progress since 1978

This section focuses on financial development, broadly defined to include improvement in the level of financial activity, the stability of the banking sector, and the quality of resource allocation as reflected in real sector performance (i.e., growth). Since the early 1980s, financial depth in China has been impressive. The real monetary balance has expanded at a rate faster than the real economy. Financial depth as measured by the ratio of M2 to GDP has increased from 24 percent in 1978 to 182 percent in 2004. This ratio increased by 30 percent in 1994-1999 and by 50 percent in 1999-2004

In comparative terms, the economic performance of China, compared to a similar transition economy such as Russia, has been remarkable. 1990, the level of loanable funds (proxied by M2/GDP ratio) was at 71% and 70% respectively for China and Russia. However, China moved to 103% in 1995 and 182% in 2004 while Russia shrunk to 21% in 1995 and 29% in 2004 (the last Russian figure is in fact what the Chinese level was in 1980 (IMF, 2004)). Such a high level of financial depth puts China among the most advanced economies. This striking financial deepening is mainly due to two factors: the monetization of the economy and the expansion of household's financial savings.

In 2001, households' deposits accounted for 77.9% of quasi-money and 47.2% of broad money (Chen, 2003).

Finally, domestic loans, taking the place of state budget appropriations, become the primary external source for financing capital investments. In 1981, state budgetary appropriation, financed 28.1% of total fixed asset investment, while the share of domestic loans was only 12.7%. By 2001, the State budget had lost its importance, while loans became the primary means of external finance (Chen, 2003).

An ultimate measure of financial development is the share of savings and time deposits in the M3 money stock. It shows the depth of financial intermediation in banking—how much credit there is available for long-term investment beyond the financing of short-term payments.

This can be observed through the trend of money components over time.

- The ratio of currency (outside banks) has evolved as follow: 20% of total money supply in 1985, 17% in 1991 and 17% in 2003.
- That of transaction deposits (demand deposits and checkable deposits) has moved from 42% in 1985 to 31% and has remained constant since.
- The ratio of non-transactions deposits (savings and time deposits) has increased sharply from 38% in 1985 to 52% in 1991 and 58% in 2003 (Bernstam and Rabushka, 2004).

Finally, commercial bank lending to firms and households as a percentage of GDP reached 142 percent for China, which was twice that of the U.S. (at 70 percent). This dynamic picture shows how the Chinese banking sector has moved from transaction-related operations (short term activities) to a long-term resource system. By all these measures, China's financial system looks solid and capable of promoting sustained economic growth.

The development of inter-bank markets in recent years has improved the liquidity of banks and other financial institutions and has aided the ability of the central bank to conduct monetary policy through open market operations. Open market operations have become a key policy instrument (Wang, 2000). By now China has basically established the securities futures market, the money market and the inter-bank foreign exchange market. Second, the financial market has fostered diversified participants. Products in the market have gradually been diversified. Compared with developed economies, however, the Chinese financial market is still lacking in product varieties and lacks sophistication.

In recent times, China has accelerated joint-stock reform of the commercial banks, taking advantage of the strong economic growth momentum. According to Li (2004), commercial bank reform has undergone several important stages. For instance, in 1998 the Chinese government issued special treasury bonds amounting to RMB 270 billion yuan. The funds raised were subsequently used to recapitalize the state-owned commercial banks.

- In 1999-2000, four asset management companies (AMCs) were established to take over part of the non-performing loans from the commercial banks.

- Second, commercial banks used their own resources including reserves, profit and capital, to write off non-performing loans.
- Third, US\$ 45 billion foreign exchange reserves were used to recapitalize two state-owned commercial banks - the Bank of China and China Construction Bank.

The banking system as a whole has improved asset quality, capital adequacy and capacity to withstand risks (Li, 2004)

The impressive economic growth happening in China has often been explained as essentially resulting from the huge capital inflows. While it may seem natural to argue that FDI may have been behind the strong economic growth rate in China, it is important to recognize that the spillovers for the host economy crucially depend on the extent of the development of domestic financial markets. There are different ways in which financial markets are significant. For instance, to take advantage of new investment and inherent new knowledge, local firms need to alter everyday activities and, more generally, reorganize their structure, buy new machines, and hire new managers and skilled labor. In most cases, external finance for doing these things is restricted to domestic sources. The lack of financial markets can also constrain potential entrepreneurs. FDI, without an efficient domestic financial system, cannot have the full/total/undiluted impact on economic growth.

The private sector's access to bank loans is still extremely limited. In the fourth quarter of 1999 private enterprises received only 0.62 per cent of the loans from all banks, and less than 0.5 per cent of all loans from state banks. This is despite the fact that private enterprises contributed nearly 35 per cent to industrial output in 1998 (Bernstam and Rabushka, 2004).

Judging by applying free-market economy standards, the financial services gap is found to be larger for developed countries. The Chinese financial institutions are plagued by poor asset quality, capital inadequacy and lack of diversification of its products. There exists a big gap between the Chinese and foreign financial institutions in terms of business operations, management skills and staff quality. In the 2nd quarter of 2004, non-performing loans recorded by the SOBs reached RMB1.8898 trillion accounting for 19.2 percent of their credit assets.

Despite the success of the Chinese financial development, many critics have evoked numerous reasons highlighting its inefficiencies. Without denying some of their statements about inefficiency, however, there certainly are some areas in which their interpretations simply have been biased.

3. Chinese financial development: re-interpretation

This section discusses the goals and effectiveness of the Chinese financial system as well as providing justification of selected policy choices taken by the authorities.

3.1. Goals and effectiveness

Every government wishes to have resources to serve its strategic goals. The objective of a State Owned Bank in a transition economy is to maximize the development impact of lending, subject to the necessary condition that its operations remain solvent. This objective is considerably different to that of a private commercial bank in a market economy. For instance, Chinese banks have been required to support government objectives ranging from the expansion of Government-chosen priority sectors to the expansion of unprofitable state-owned enterprises. Due to policy lending, the role of the central bank in reallocating loanable funds—from regions of high to low growth, and the continued reliance on administered interest rates—offer examples both of which suggest an environment in which financial institutions are part of the government bureaucracy and development institutions rather than part of market institutions. Financial intermediaries may not have directed financial resources efficiently in a strictly economic sense, but they have certainly achieved the development goal of income redistribution. This latter has consequently contributed to boost domestic demand as well as a cycle of income-savings generation across all provinces.

Examining the productivity of investment funded through domestic loans using Chinese national level data Laurenceson and Chai (2001) concluded that Investment funded through domestic loans has been productive, at least when compared with other investment funding sources. Similar results were obtained by Liu and Li (2001) who attempted to shed light on the same issue using provincial level panel data.

An example of an erroneous perception of the Chinese financial institutions is the focus on the high level of non-performing loans of SOBs. The ratio of Non-performing loans/listed capital of Chinese SOBs rose from 1.3 in 1993 to 6.0% in 1997, before falling to 4.7% in 1999. Although high by the standards of industrial economies, this ratio does not appropriately reflect the efficiency of financial institutions since the listed capital of those banks does not reflect their ultimate liabilities when their owner (the Chinese government) is willing to back them. The strength of banks is generally measured by the ratio of capital to assets; the size of reserves held relative to the quality of outstanding loans; profitability; and the margins between lending and deposit rates. The ratio of capital to assets of China's 4 largest banks fell from 12.1 % in 1985 to 2.2% in 1996 (Lardy. 1998)

The profitability of Chinese banks was relatively stable at about 1.4% in 1985-1987 but has fallen sharply since then. During the 1990s, the reported profitability of Chinese banks compared reasonably well with that of major international banks in the mid-1980s. However, by the mid-1990s their returns were well below those of banks of comparable size in market

economies. Chinese banks in the mid-1990s look good only in comparison with large Japanese banks at the beginning of the current banking turmoil in Japan. (Lardy, 1998).

According to Park & Sehart (2001), the central Chinese government regards loans as a means for achieving regional equality. It uses the financial system, especially the state banking sector, for implicitly taxing rich provinces and subsidizing poor provinces: financial resources are channeled into poor provinces for supporting their credit expansion (Park and Sehart, 2001). This argument is confirmed by Chen (2003) who demonstrated that provinces with a lower level of economic development have been receiving preferential credit treatment from the central government. Since it is influenced by political concerns, the actual loan distribution may differ from the optimum distribution according to economic fundamentals.

The issue of efficiency has been based on the declining financial performance of SOBs, however, Laurenceson and Chai (2003) point out that such a decline does not reflect allocative inefficiency in the SOBs' lending. This is because it has long been recognized that projects that have great development significance may only yield a marginal financial return. That is, due to the existence of market failures, there is often a large divergence between social and private returns to lending. For this reason, Stiglitz (1994) argues that there can be no presumption on the basis of economic theory that a liberalized financial sector will optimally allocate credit. The exclusive use of financial measures to gauge the performance of SOEs and SOBs is also inappropriate in that they are trying to satisfy a range of objectives (economic development objectives, social objectives, and so on) in contrast to firms and banks in a purely market economy that are solely attempting to maximize profits.

Contrary to dire predictions of financial collapse, China demonstrated the robustness of its financial systems in that it was less vulnerable to financial fragility as compared to those countries badly hit during the Asian financial crisis. Financial fragility can impose heavy costs on taxpayers and disrupt the real economy through reduced availability of credit and other services such as payments (Goldstein and Turner, 1996).

As Darwin told us, plants and animals evolve over time, and the survival of the individual and of the species as a whole depends on how well it fits with its environment. "Survival of the fittest" does not mean "Survival of the one that takes the most exercise", it means survival of the species/individual that best matches its surroundings. The same applies to financial institutions. It is not the specific characteristic of a financial institution that makes it intrinsically 'useful' or 'not useful', but how well that institution matches or fits the economic environment and overall development goals. The fit does not emerge naturally, but comes about in response to voluntary policies implemented by monetary authorities in conformity to the overall development goals.

3.2. Financial and Monetary Policies

The usual way for a government to support particular activities is by controlling interest rates and sectoral credit allocation. China's central bank has been keeping interest rates low to meet its development goals. Further, a review of the traditional missions of the 4 Chinese largest banks discussed in section 2 reveals a clear concentration of each of them on a particular sector, with a specific development orientation.

One positive result of tight government control can be found in the China's remarkable immunity to the Asian financial crisis. In fact, the Chinese financial firms have not been able to take up risks (such as foreign currency risk or some derivatives risks) that could have lead them to a sudden collapse, as has occurred in some of China's nearby countries during the Asia financial crisis (Xinghai, 2001). The partial convertibility of the Renminbi made it far less vulnerable to speculative attacks. The Renminbi was not convertible for capital account transactions. Instead, it was only convertible on the current account, which meant that official documentation of a legitimate trade or other approved transaction was required before permission can be obtained for changing money

Direct intermediation controls such as credit ceilings specified in the annual credit plan have been of far greater consequence in China. This traditional tool of credit control set limits on the total lending of each financial institution and sub-ceilings for certain categories of loans (World Bank, 1990). Decisions about lending can only be made appropriately if bankers have the necessary inputs to make judgments about the risks and returns of the firms to whom they advance funds. Debtors need to make this information available through high levels of disclosure – an issue not just in the area of developing financial systems such as the Chinese one. In China, private firms find it difficult to communicate information about the firm to financial intermediaries. On their side, financial institutions, particularly SOBs, have little experience in assessing credit risk or the potential for profitable investment opportunities.

To cope with problems generated by asymmetric information, financial restraint policies have proved to be necessary in China. The increased profitability of financial institutions due to financial restraint policies could lead to (a) more confidence on the part of savers in the stability of formal financial institutions and hence a greater willingness to hold financial assets independent of interest rate factors, and (b) increased investment in deposit collection infrastructure that will reduce the transaction costs incurred by savers when accessing the formal financial system. This will again have the effect of increasing financial depth in a manner independent of the interest rate.

Chinese SOBs have generally held reserves that have been in excess of that required (Girardin, 1997); that simple fact may suggest that an increase in the reserve requirement may not actually lead to increase in the level of financial repression by reducing the overall level of intermediation provided by the SOBs. Given the fact that China has yet to establish a deposit insurance system, and that quite a number of financial institutions have failed to reach the 8%

capital adequacy ratio, the differentiated required reserve ratio scheme is conducive to curb excessive credit expansion of the financial institutions with low capital adequacy ratio and poor asset quality, and to prevent the one-size-fits-all approach in macro financial adjustment and regulation (Wu, 2004)

The lending practices and central government control appears to be an effective monetary tool.

Although proponents of the theory that financial repression occurs cites controlled interest rates as one of the tools of financial repression, the case of China has proved to be an exception. Even McKinnon (1994) has implicitly recognized the necessity to take recourse to financial restraint policies when admitting that China's interest rate policy, particularly on saving deposits, remains very important in preserving the incentives of households and enterprises to build up their financial asset positions. Except in very short episodes of inflation (from 1988 to 1990 and from 1993 through April 1996), Chinese authorities have been successful in maintaining a positive deposit rate in real terms by, for instance, instituting the so-called value-guarantee deposits (which were designed to insulate long-term deposits from inflation).

Policies and reforms, either monetary or financial, are effective if and only if economic agents trust them to work in their interests. In China the general public's confidence in the financial system has been and remains high. While it is generally admitted that financial liberalization improves banking efficiency, this might not be the case in China because of the very fact that banks are owned by the state reassures the depositors.

The commitments China made when joining the WTO and the requirements of the Chinese economy itself call for the accelerated development of the financial market. The ratio of foreign trade to GDP in China has reached 60% in 2003. Viewed objectively, the Chinese financial institutions are required to provide corporate customers with a series of financial services such as arbitrage, risk control and FX cash management. The expansion of the market demand opens windows of opportunity for the development of the financial market and financial products. (Zhou Xiaochuan, 2004).

Over the past decade Chinese financial systems have been going through major changes. These developments raise new questions and unlock new challenges. In order to provide an appropriate response to these new and changing circumstances, Chinese policymakers have engaged in further market-based interest rate reform, with significant progress achieved in the deregulation of money market interest rate. The floating band of interest rate on loans to small and medium sized enterprises has been enlarged to three times its original size, leading to improved risk management capability of the banks and enabling these enterprises to have easier access to bank credit.

The solution to China's financial problems depended in part on devising policies to use the

country's high level of savings in an appropriate way. One mechanism would be to transform private savings – at present largely held as deposits with state banks – into bank capital. In this way, banks might meet the 8% capital requirement target.

There is a need for a strong regulatory and supervisory framework for the smooth operation of the financial sector— for helping to improve efficiency, safety, liquidity, for increasing the efficient transfer of information, increasing diversity and adding to financial discipline.

4. Conclusion and Perspectives

The tremendous financial development achieved by China over the last two decades has been impressive in the areas of financial depth, savings mobilization and credit allocation. Dominated by state owned banks, the financial system has shown strength in channeling funds according to development plans. Financial depth has reached the level of advanced economies and financial intermediation in banking increased dramatically while shifting from short-term to long-term operations. Despite such success, critics have pointed out numerous inefficiencies. While some of those criticisms are valid in market economies, the present essay has emphasized the inappropriate character of strictly financial standards for judging Chinese SOBs' efficiency.

The robustness of the both the Chinese financial system and implemented policies have been seen, not only through the strong economic growth achieved, but also via the remarkable immunity of China to the Asian financial crisis. These two outcomes could not have been achieved if the financial system was inefficient or inadequate. Indicators such as the ratio of capital to assets and profitability may not fully make sense in a transition economy with strong socio-developmental emphasis (rather than adherence to strict financial considerations) and where most (if not all) institutions are still state-owned. In such a case, efficiency of institutions depends more on the willingness of the government to keep them operative and less on whether their capital can cover their assets or the lack of profits.

In addition, the discussion also looked into the policies implemented by the Chinese authorities in the light of financial restraint, such as directed and sectoral credit allocation, rather than financial repression. These two perspectives allow getting a much better understanding of the Chinese financial system, which is compatible with the strong economic growth achieved by China since 1978. In many respects the misinterpretation of the Chinese financial development follows the common belief in financial development that an inherent tradeoff exists between social and financial return: greater social return implies lower financial return, and vice-versa. For most analysts, the practical consequence is the dominance of financial return over social return in the hierarchy of values.

In terms of global perspective, it should be noted that after joining the WTO, China has come to the stage where further financial market reform is critical to its ability to secure a successful integration into the global financial market. The Chinese financial sector has been effective in the past but it is unlikely to be strong enough to face competitive pressure from foreign institutions. Regarding future reforms, the level of non-performing loans and the risk of insolvency constitute major constraints on China's plan to liberalize interest rates. Further, guidelines on BIS capital adequacy require that market reforms be accelerated and further recapitalization of the banking system be undertaken. More than in the past, the health of the Chinese financial system is going to play a central role in sustaining the global economy; understanding its current state and prospect are therefore crucial.

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